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UNCLAS SECTION 01 OF 02 FRANKFURT 005048

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E.O. 12958: N/A
TAGS: ECON EFIN EUN
SUBJECT: German Finance Agency Issues USD Bond

T-IA-F-05-030

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¶1. (SBU) Summary: The German Finance Agency made news with its first borrowing in US dollars since World War II, a cool USD 5 billion. The move was taken in response to Asian demand and to save money, but does not mark the beginning of a regular dollar-borrowing program by the German Agency. German Bunds continue to be a benchmark issue in a euro bond market that has grown to be larger than the USD market. End Summary.

First USD Borrowing Since WWII
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¶2. (SBU) On May 24 the German Finance Agency made news with its first borrowing in USD since World War II. The German Finance Agency, formerly part of the Bundesbank, is the borrowing agent for the German Government and reports to the Ministry of Finance. The USD 5 billion, 5-year issue was over subscribed with bids hitting USD 13 billion to yield 12 points over comparable US Treasuries. Market participants speculate there could be more such German USD offerings in the pipeline.

¶3. (SBU) The head of the Agency explained to us that the USD issue was undertaken to save the Finance Ministry money, a principal objective of the Agency. During a spring trip to Asia and the Middle East, he detected strong demand for USD assets and a desire to diversify away from US Government paper. Asian investors with whom he spoke thought the Euro was over priced and expected the USD to recover. He reported that, in the event, Asian investors purchased 60% of the issue and 50% of the total went to central banks. The low interest rate allowed the agency to save 13 million euros, even after the issue was fully hedged so that it has only euro liabilities.

Other New Features Yet to Come?
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¶4. (SBU) New euro sovereign borrowing techniques have begun to attract attention. France has inflation-linked bonds and in February issued a 50-year bond. The French bond had an initial size of 3 billion euros but was doubled when it attracted euro 19.5 billion in bids. The spread to the 30-year French benchmark issue was a mere 3 basis points, a feature that European Central Bank President likes to cite as confidence in the long-term value of the euro.

¶5. (SBU) The German Finance Agency is likely to issue an inflation-linked instrument and has just about completed the necessary technical work, but the agency head doubts it would produce any cost savings. Such instruments can be cheaper than straight bonds in environments where inflationary expectations are high but measured inflation actually falls. Inflation expectations are low in Germany. In fact, the Bundesbank never did an inflation-linked issue as it would have conflicted with its stated objective of price stability.

¶6. (SBU) He doubts the Agency would do a 50-year bond issue. There is little liquidity in that segment. He pointed out that most of the French issue was placed with hedge funds, not long-term investors like pension funds. That said, he agrees with the Bank for International Settlement's (BIS) assessment that there has been strong demand for longer-dated instruments. This reflects a desire for higher yields and some recent supervisory requirements for institutions, such as pension funds, to match better the duration of their assets and liabilities. In fact, the German Finance Agency has extended the maturity structure of its borrowings, doing more 29- and 30-year issues than the

Bundesbank.

## Growing Eurobond Market, but Still Obstacles

¶7. (SBU) The euro bond market continues to grow and now surpasses the US market, according to the agency head. BIS statistics show that in 2003 and 2004 the value of the gross issuance of euro-denominated international bonds and notes topped those denominated in USD. In the first quarter of 2005, euro issuance of these instruments totaled $572 billion compared to $306 in USD. While gross euro issuance is typically strong in the first quarter, the BIS notes this year's extraordinary 22% advance reflected favorable financing conditions to restructure balance sheets, particularly in growing markets.

¶8. (SBU) However, the euro bond market for sovereign issues is not really a unified market, according to the head of the Agency. Some European countries offer tax breaks to residents when they purchase local government bond issues, others maintain a market- maker system requiring participating banks to support their government issues by providing liquidity in the market. The German Finance Agency is unique in that it has no primary dealer system, but buys and sells directly in the market and offers no special features to traders. German bonds are the market benchmarks and are much in demand. "I like competition," he concluded.

¶9. (U) This report coordinated with US Embassies Berlin and Paris and USEU.

¶10. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238

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